# NATIONAL FORECAST DESCRIPTION

## The Forecast Period is the Fourth Quarter of 2004 through the Fourth Quarter of 2008

It appears spring has brought renewed optimism about the national economy. This can be seen in many key indicators that have been revised upward since the last *Forecast* was published. Nominal GDP is not only higher than the previous projection, but actually grows faster. Specifically, nominal output is anticipated to increase an average of 5.4% over the forecast period, which is noticeably quicker than the 5.0% pace forecast in January 2005. As a result of this faster growth, the gap between the current and previous nominal GDP projections, expressed as a percent, rises from 0.6% in 2005 to 1.2% in 2008. Interestingly, the gap between the two output estimates remains at about 0.5% in all years even when both are adjusted for inflation. This is because inflation is higher in the current forecast than in the previous one. The annual differences between the current and previous forecasts for U.S. real personal income are about 1.1% per year, which are even greater than the ones for real GDP. The outlook for U.S. nonfarm employment has also improved, so that it is 0.2% to 0.5% higher each year compared to the previous projection.

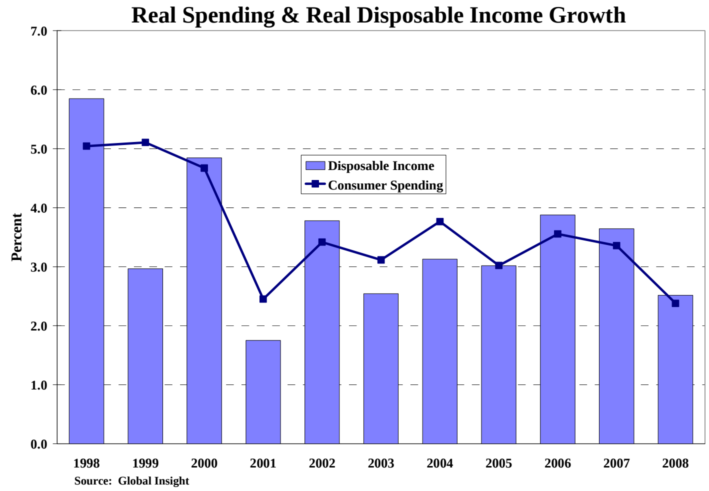
The economy performed admirably last year and it should perform well again in 2005. According to the U.S. Bureau of Economic Analysis, real GDP advanced 4.4% in 2004. Not only was this its strongest showing since 1999, but it was also growing much faster than its estimated potential of 3.3%. Nonfarm employment grew 1.1% in 2004, which was its first year-over-year gain in three years. And the pace of real personal income growth accelerated from 1.3% in 2003 to 3.3% in 2004. This year promises to be a lot like last year, and in some cases it should be better. Real GDP is forecast to advance 3.7% in 2005. While this is slower than in 2004, it is still slightly above its potential. On the other hand both nonfarm employment and real personal income should advance at a healthier clip in 2005 than in 2004. Specifically, U.S. nonfarm employment is expected to increase 1.7% and real personal income should rise 3.8%.

Economic growth is expected to cool gradually after this year. Real GDP growth should average about 3%, which is below its potential. Employment and income will also slow. For example, real nonfarm employment is anticipated to grow 1.4% in 2006, 0.9% in 2007, and 0.7% in 2008. One piece of good news is U.S. manufacturing employment, which has declined most of this decade, is forecast to grow in both 2006 and 2007. Real personal income should rise 3.8% in 2006, 3.3% in 2007, and 3.4% in 2008.

One thing that remains from the previous forecast is high priced oil. It was previously projected the spot price for West Texas Intermediate (WTI) oil would peak at $46.13 per barrel this year then gradually retreat to $34.14 per barrel in 2008. However, price spikes since then have led economic forecasters to rethink and revise their oil price projections. The current forecast calls for the WTI spot price to average $45.82 per barrel this year and drop to $34.70 in 2008. While higher oil prices have not yet triggered runaway inflation, their impacts are being felt. According to the Department of Labor, the energy component of the CPI rose 2.0% from January 2005 to February 2005—its biggest change since October 2004. The Department of Labor has determined this increase accounted for virtually all of the acceleration of the overall CPI. The transportation component of the CPI also felt the sting of higher oil prices.

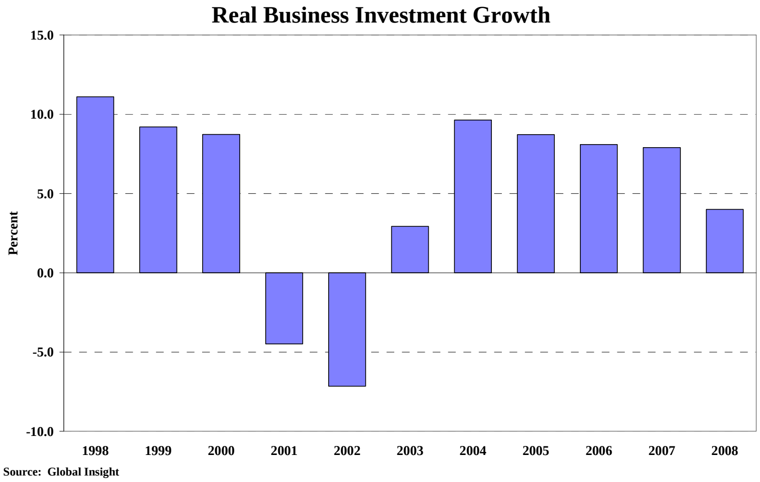
In summary, the U.S. economy gained strength in 2004. Some of the momentum from last year should carry over into 2005, also making it a year of healthy growth. The U.S. economy should continue expanding after this year, but its rate of growth is expected to slow over time.

## SELECTED NATIONAL ECONOMIC INDICATORS



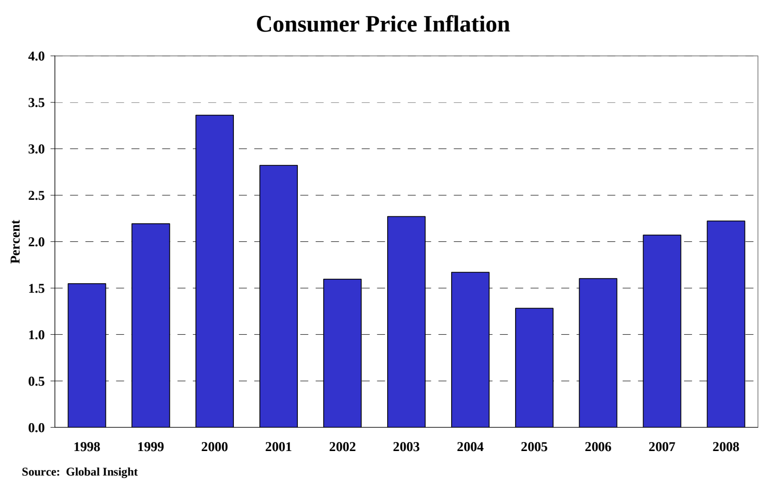

**Consumer Spending:** After carrying the U.S. economy on its huge shoulders for several years, the consumer sector should finally receive some help keeping it aloft. The strength in real consumer spending helped make the 2001 recession one of the mildest on record. According to the National Bureau of Economic Research, the average U.S. recession lasts 17 months. At eight months long, the 2001 recession's duration was less than half the historical average. Another measure of a slowdown's severity is the decline in national output. Records show real GDP declined a modest 0.2% from its pre-recession peak in the last quarter of 2000 to its trough in the third quarter of 2001. In contrast, real GDP shrank 1.3% from peak to trough during the 1990-1991 recession. A major difference between the two recessions was the behavior of the consumer sector. Of the two slowdowns, the 1990-1991 slowdown was the more typical. During this period, real consumer spending declined 1.1%. In contrast, real consumer spending grew through the 2001 recession. This strength was an important offset to other sectors that were dragging down output. For example, real business investment declined for the nine successive quarters from the fourth quarter of 2000 to the first quarter of 2003 and the net export deficit swelled from $397 billion to $512 billion. The consumer-spending share of GDP rose to 71% in 2003, which is significantly higher than its long-run (1959-2004) average of 65%. It should be noted spending remained resilient despite some serious challenges to consumers' confidence, such as the Iraqi War, the stock market correction, and lackluster job growth. However, these concerns appear to have been no match against the lure of new automobiles, consumer electronic goods, and low interest rates. Not even slow income growth could keep American consumers away from the mall and out of automobile showrooms. As in the past, Americans emptied their piggy banks and took on debt when their desires grew faster than their means. And low interest rates helped justify this action. Low interest rates made higher debt loads more affordable and lowered the incentive to save. Low interest rates had another important impact. They made home refinancing attractive. Many homeowners cashed out a portion of their equity or took out home equity line of credit. This provided additional cash for the consumers' shopping spree. Federal income tax cuts also helped thicken Americans' wallets. Moving forward, consumers will not be able to depend on some of these factors. The Federal Reserve has already begun raising rates and the growing federal deficit makes further tax cuts unlikely. In addition, the U.S. personal savings rate is under 1%, so this source of funding is nearly tapped out. Absent these options, it appears consumers will have to live within their means. Real consumer spending will grow about 3.0% per year, which is about the same pace as real disposable personal income.

**Business Investment:** After lying dormant for several quarters, real nonresidential business investment roared back to life in 2004, posting its first double-digit year-over-year gain since 1998. Last year's impressive 10.6% increase was fueled in large part by the strong recovery of business spending on equipment and software. The 13.5% increase in equipment and software spending was a welcome change from 2001 and 2002 when spending retreated and 2003's relatively mediocre showing. Last year's gain was not unexpected. Most forecasters believed equipment and software spending would accelerate in order to take advance of favorable tax treatment for investments that expired at the end of 2004. However, they also feared 2004's success might prove to be a double-edged sword that would suppress investment in 2005. This is because it was assumed a portion of the increased investment in 2004 resulted from sales that would have taken in place in 2005 being moved into 2004. For example,

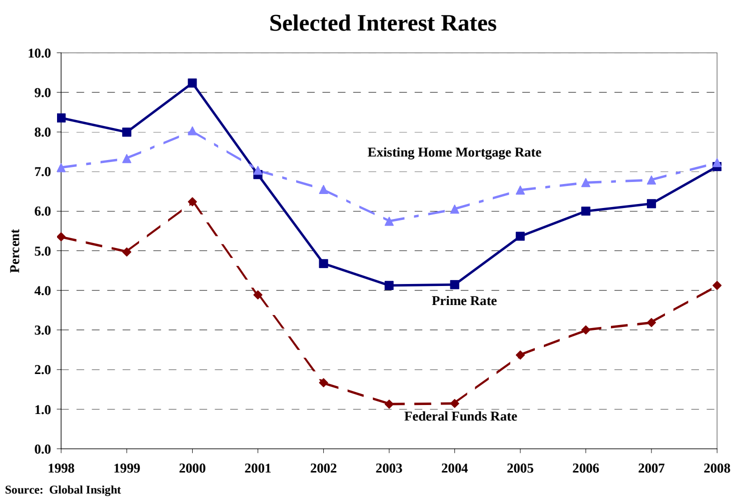



in November 2004 it was projected real investment in equipment and software would drop to a 2.1% annual pace in this year's first quarter. Interestingly, there is no evidence investment has dropped off so far in 2005. There are a couple of reasons investment has not dropped. One reason is the financial accelerator effect. Proponents of this theory believe investment is tied to recent changes in GDP growth. Specifically, financing investment projects is easier when the economy is growing quickly than when it is growing slowly. According to the *Economic Report of the President for 2005*, investment picked up in 2003 and 2004 because GDP growth accelerated in 2001 and 2002. The second reason is businesses may have changed their outlook of the future. In the recent past, investment could have been hindered by uncertainty. It appears businesses may have finally shaken of their fears and are more positive about the economy's future. Indeed, the economy is on more solid footing, and the consensus is that it will expand for several more years. This has led to an upward revision of the investment forecast. It is now believed real spending on equipment and software will rise at a 14.2% annual rate in the first quarter of this year and an 11.0% rate in the second quarter. This strong start should help equipment and software investment repeat last year's 13.5% gain in 2005. After posting double-digit growth in 2004 and 2005, annual spending on equipment and software is forecast to slip into a single-digit pace in the remaining years of the forecast, and overall business spending will follow suit. Specifically, real business spending on equipment and software should advance 13.5% this year, 6.3% next year, 5.9% in 2007, and 6.0% in 2008. Overall business investment is forecast to increase 11.6% in 2005, 6.6% in 2006, 5.0% in 2007, and 4.8% in 2008.

**Inflation:** Soaring oil prices are once again fueling inflation fears. Last fall oil prices rose above $50 per barrel. This increase was blamed on strong world demand and the loss of supply resulting from hurricanes in the Gulf of Mexico. The impact of rising energy prices has been documented by the U.S. Department of Labor. According to its most recent consumer price index, the energy component jumped 4.0% from September 2004 to October 2004—the largest increase of any price category for that period. Not surprisingly, the transportation category also reflected the sting of higher oil prices; it jumped over 2%. Overall consumer inflation increased 0.6% from September to October, which was three times faster than the increase from August to September. This price surge was short lived. By December of last year and January the rate of inflation had slowed noticeably as energy prices retreated. Since then, energy prices have accelerated. According to the Department of Labor, the energy component of the CPI rose 2.0% from January 2005 to February 2005—its biggest change since October's jump. The Department of Labor has determined this increase accounted for virtually all of the acceleration of the overall CPI. The transportation component of the



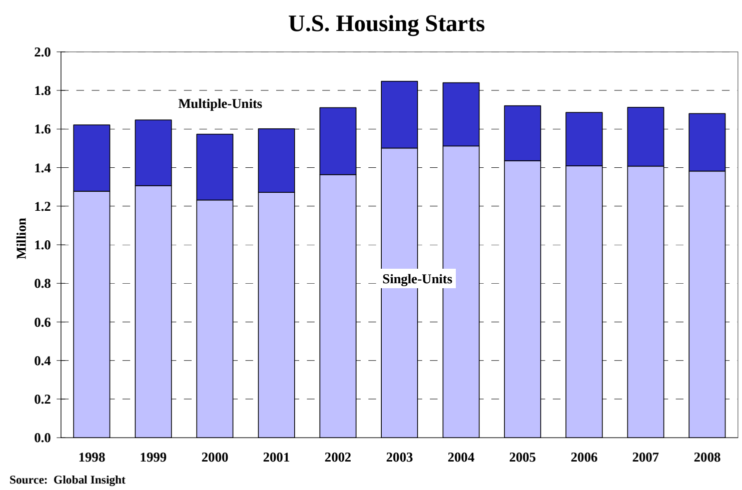
CPI also felt the sting of higher oil prices, rising by 0.8% in February. Of course, consumers do not need to peruse government statistics to measure the impacts of higher oil prices; they are reminded of it every time they fill their gas tanks. Gasoline prices moved above $2.00 per gallon in early March 2005. Specifically, the all-areas, all-formulations price was $2.098 per gallon in the second week of March, which was three cents above its October 2004 peak. Despite the noticeably higher oil prices, inflation is not expected to accelerate over the forecast period. Specifcally, the forecast for overall inflation in 2006 is the same as the projection reported in the January 2005 *Idaho Economic Forecast*. The inflation forecasts for the remaining years of the forecast are just slightly higher than had been previously published. One of the reasons inflation should remain tame is annual employment cost increases should remain under 4%. The most obvious wildcard is employers' health insurance costs. Should these costs rise faster than anticipated, overall inflation will heat up.




**Financial:** There have been few surprises at the nation's central bank. The Federal Reserve raised its federal funds rate by 25 basis points twice this year, bringing the rate to 2.75% in early spring. It appears the central bank is attempting to raise the federal funds rate to a level that will afford it more maneuvering room in the future. Recent experience shows why this is important. In an attempt to kick-start the stalled U.S. economy the Federal Reserve began lowering the federal funds rate in January 2001. By June 2003 the federal funds rate had fallen 550 basis points to 1%, where it remained for about a year. This year proved stressful because, with the federal funds rate so low, the central bank risked losing its favorite policy tool. It was if the Federal Reserve, which had so adroitly balanced on the razor's edge between growth and inflation, was in danger of running out of razor. Ironically, the low inflation environment that allowed the Federal Reserve to lower rates threatened to become a deflation environment in 2004. Fortunately, this never occurred. The Federal Reserve began tightening in June 2004. It remains to be seen how high the federal funds rate will rise. This forecast assumes the federal funds rate will be increased gradually to about 4% by year's end, where it will remain through most of next year. This implies the real interest rate (nominal interest rate less the inflation rate) will be about 2% in 2006. After pausing next year, the federal funds rate is projected to gradually rise to 4.25% in 2007 and 4.52% in 2008.

**International:** The outlook for the global economy has improved in recent months as a result of the continued resiliency of U.S. import demand, a reacceleration of China's sizzling economy, and renewed signs of life in the Eurozone's off-again, on-again expansion. Specifically, over the next few years the global economy should expand about 3.2% per year. Of course, growth will vary by region. Asia is anticipated to enjoy the strongest growth. This region's (and the world's) hottest performer is China, which should expand an average of over 7% per year. All other Asian countries except for Japan should also display healthy growth. Japan is the laggard; its output should increase by less than 2% over the next few years. At this pace, Japan will not only lag the emerging Asian economies, but will also trail many countries with developed economies. The only region whose performance is close to Japan's is the Eurozone, which is expected to grow about 2% annually. In comparison, Canada, Mexico, South America, and the United States should all advance from 3% to 4% annually over the next few years. Given the weak domestic economies of several key trade partners, it appears any improvements to U.S. export trade will depend on a further retreat of the greenback. The dollar's retreat should also stem the flood of imports because it raises the price of foreign goods relative to domestic goods. An important exception to this is China because its currency is tied to the U.S. dollar. Anyone expecting the declining dollar to provide a quick fix to the nation's swelling trade deficit will be disappointed. Because trade volumes take longer to respond than changes in the dollar's value, the nominal U.S. trade deficit will get worse before it improves. The current account deficit is expected to exceed $770 billion in 2005, or about 6.2% of GDP. It should shrink slowly thereafter, and is predicted to be around $730 billion in 2008. This nagging trade imbalance reflects the fact that the global economy remains far too dependent on the U.S. economy.

**Employment:** National nonfarm employment should post its strongest growth of the forecast period in 2005 and 2006. Confident the economy is on solid footing, U.S. businesses are expected to expand payrolls by 1.7% this year and 1.4% next year, which is significantly faster than 2004's 1.1% growth. While the growth rate may be different, 2005's employment growth pattern is similar to 2004's. Last year it was difficult to draw a bead on monthly employment changes because it was so volatile. In some months nonfarm employment grew above expectations and in others months it was below expectations. This pattern has continued into 2005. A review of the U.S. Department of Labor's *Employment Situation: March 2005* reveals nonfarm employment grew by a disappointing 110,000 jobs from February 2005 to March 2005. Most analysts were hoping the March job gain would be closer to the February 2005 increase of 238,000 jobs. The economy eked out just over 100,000 jobs in January 2005. Despite suffering a few disappointing months, the U.S. employment trend is positive. For example, U.S. nonfarm employment has increased in every month since late 2003. Another testimony to the labor market's strength is the full percentage point decline in the unemployment rate from 6.2% in June 2003 to 5.2% in March 2005. Another positive sign is the job losses that have plagued the manufacturing sector for several years are projected to end in 2005. Overall, U.S. nonfarm employment, after growing 1.4% in 2006, should rise 0.9% in 2007 and 0.7% in 2008.




**Housing:** Last year was a banner year for the nation's housing sector. Existing home sales totaled 6.61 million units, with new home sales accounting for 1.18 million of that total. Both were well above their 2003 showing, and earned them places in the record books. Single-family starts and permits also secured their places in history with strong performances last year. Total housing starts and permits did not set records in 2004, but deserve accolades nonetheless. While the housing sector was expected to do well, no one anticipated its record-setting showing. For example, in Global Insight's December 2003 U.S. macroeconomic forecast both total housing starts and total housing sales were expected to drop slightly in 2004 from its 2003 pinnacle. This outlook reflected the negative impacts of anticipated interest rate increases that would raise the 30-year fixed mortgage interest rate from 5.83% in 2003 to 6.44% in 2004. The Federal Reserve did tighten, but mortgage rates barely budged to just 5.84% in 2004. The housing sector was also bolstered by other factors, including strong real disposable income growth, historically low unemployment rates, and sanguine homebuyers. Another important component was above-normal housing price appreciation. According to the Office of Federal Housing Enterprise Oversight (OFHEO), U.S. housing prices rose 11.2% from the fourth quarter of 2003 to the fourth quarter of 2004. Interestingly, housing has performed better than stocks over the last five years. Specifically, U.S. housing prices appreciated about 50% since 1999, while the stock market actually declined nearly 15%. A market this hot raises fears of a housing bubble. Indeed, there are some regions that are at high risk. PMI Mortgage Insurance Company (PMI) recently published a report covering the vulnerability of the nation's 50 largest housing markets. After considering several economic factors, PMI determined the housing markets with the greatest risk of falling house prices was Boston-Cambridge-Quincy, MA-NH; San Jose-Sunnyvale-Santa Clara, CA; San Francisco-Oakland-Fremont, CA; San Diego-Carlsbad-San Marcos, CA; and Providence-New Bedford-Fall River, RI-MA. The U.S. housing sector is expected to gradually retreat from its recent highs without suffering any serious calamities. For example, existing housing sales prices should continue rising, but nowhere near 2004's 8.8% pace. After reaching nearly 2.0 million units in 2004, U.S. housing starts are predicted to be 1.9 million units in 2005, and about 1.7 million units in 2006, 2007, and 2008.